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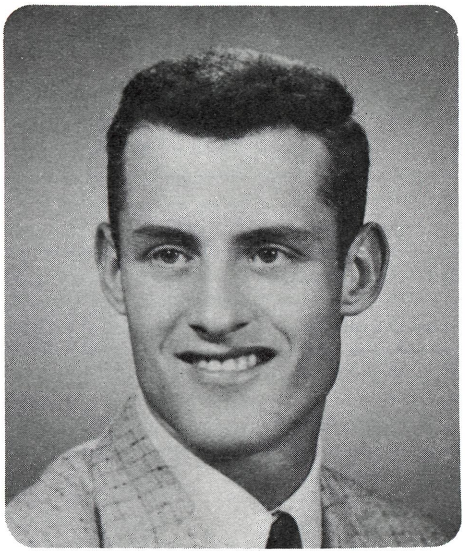
by Homer Gilchrist



Homer R. Gilchrist, audit supervisor in our Phoenix office, came to TRB&S in 1959 and spent three years in our Detroit office before moving to Phoenix. He was an economics major at Oberlin College and received his B.A. in 1958. He received his M.B.A. from the University of Michigan in 1959. Mr. Gilchrist is a member of the American Institute of Certified Public Accountants, a member of the Arizona Society of Certified Public Accountants, where he serves on the Reporting Standards Committee, and a member of the American Institute of Internal Auditors. He is a CPA in both Michigan and Arizona.

Do you own or manage real estate which has been condemned or is likely to be? If so, your plight is one which is becoming more widespread as the interstate highway system progresses and more communities embark on urban renewal projects. Business managers are frequently forced to relocate a plant or office building because the property on which the building is located has been condemned. Similarly, investors in real property may often have to find another investment because their real estate has been taken by a condemning authority. Condemnation proceedings not only interrupt business operations and investment programs, but in many cases result in partial or total loss of the property involved. This loss gives rise to a variety of income tax problems because of the special tax rules applicable. It is very important that the owner or manager of property about to be condemned acquaint himself with these special rules, so that he may realize the maximum tax benefit from the condemnation award.

The Tax Law of Condemnations

A condemnation of property is a tax transaction resulting in gain or loss very much as if the property were sold or exchanged. A taxable gain or loss is realized when the amount of the condemnation award either exceeds or is less than the adjusted basis of the property (that is, the cost of the property less amounts taken as deductions for depreciation, if any). If a gain is realized on the condemnation of the property, the owner will be taxed at either capital gain rates or ordinary income tax rates depending on the length of time the property was held by him. Property held for more than six months is entitled to capital gain treatment (that is, subject to a maximum tax rate of 25 per cent), but if the property is held for six months or less, the gain is taxed at ordinary income tax rates. If the condemnation results in a loss, it may be used as a deduction against all other types of income without regard to the period of time the property was held (unless the property is a personal residence, in which case the loss is not deductible).

There is a special provision of the tax law which permits a taxpayer to defer the payment of taxes on a condemnation gain. This deferral can be accomplished if the taxpayer purchases property to replace that which was condemned. If the cost of the replacement property exceeds the condemnation award, the taxpayer can elect not to report the gain in the year the award is received. However, the gain not reported reduces the basis of the newly acquired property so that the gain is deferred until the replacement property is sold. On the other hand, if the condemnation proceeds exceed the cost of the replacement property, the excess must be included in income in the year the award is received.

What Constitutes Replacement Property?

The present tax law, which applies to condemnations after 1957, requires that the replacement property be of a "like kind" to the property condemned. The words "like kind" refer to the nature or character of the property and not to its grade or quality. The essence of this rule is that real property must be replaced by real property. It does not matter if the properties vary in size, quality or location, or that one is improved while the other is unimproved. For example, a vacant lot may be replaced by a hotel, farm land may be replaced by city realty, etc. "Like kind" property excludes real estate mortgages, stocks, bonds and equipment or other personal property since none of these fall into the category of real property.

Timing the Acquisition of Replacement Property

The deferral of tax on the condemnation gain can be accomplished only if the replacement property is acquired within a certain period of time. This period generally begins on the date of earliest threat or imminence of condemnation and ends one year after the close of the first taxable year in which any part of the condemnation award is received. A threat or imminence of condemnation first exists when a condemning authority indicates by public resolution or act, or by representation to the taxpayer, that certain property is to be condemned. The important feature of this rule is that it is not necessary to wait until the award has actually been received before acquiring the replacement property. Consequently, the replacement period may be quite long since the lapse of time between the initial threat of condemnation and the receipt of the award may be substantial, particularly if litigation is involved.

There are two rules relating to the replacement period which the taxpayer must be certain to comply with. If the replacement property is a new building, construction must be completed by the end of the replacement period. Merely entering into a contract for construction of a building does not in itself satisfy the requirement. The second rule to watch out for is that the replacement property must be owned by the taxpayer on the date the condemnation award is received. That is, the replacement property cannot be purchased in anticipation of the award and then sold before the award is actually received.

The rules governing the replacement of condemned property require intricate planning in timing the acquisition of replacement property. The tax law makes no provision for the taxpayer's inability to acquire suitable replacement property within the period allowed. Consequently, the taxpayer should formulate a plan for replacement as soon as the threat of condemnation occurs.

When to Elect to Report a Condemnation Gain

The acquisition of qualified replacement property within the time period allowed permits the taxpayer to defer reporting the gain from the condemnation award. However, he may elect to report the gain and pay the tax thereon. This election should be considered carefully for it may be more advantageous to report the gain even though this procedure results in an immediate tax liability.

In situations where the replacement property consists solely of land, which is not subject to depreciation, the taxpayer should elect not to report the gain on the condemned property. The gain reduces the basis of the replacement land and is not taxed until the land is sold.

However, if the replacement property is a building, which is depreciable, the taxpayer may actually save taxes in the long run by reporting the gain and paying the tax thereon. The gain is taxable at a maximum rate of 25 per cent (provided the condemned property was held over six months), but the depreciable basis of the replacement property is not reduced as is the case when the gain is not reported. The higher depreciable basis permits greater depreciation deductions from ordinary income, which is frequently taxed at rates far in excess of 25 per cent.

The decision as to whether or not to report the gain should be based on a comparison of (1) the tax savings resulting from the increased depreciation deductions with (2) the tax which must be paid to achieve these savings. Since the tax savings will be realized only over the depreciable life of the replacement property, the annual savings should be discounted, much like an annuity. The following example will illustrate the computations and comparison:

Facts:

A taxpayer received a condemnation award of $100,000 for property with a basis of $60,000. The condemned property had been owned longer than six months. As a replacement the taxpayer acquired a building for $100,000. The building has a remaining life of 20 years.

Conclusion:

By reporting the gain, the taxpayer would incur a tax of $10,000 (25 per cent of the $40,000 gain). However, the depreciable basis of his newly-acquired building is $40,000 greater than it would be if he had elected not to report the gain. Consequently, he will have an additional annual depreciation deduc- of $2,000 for twenty years. The annual tax reduction effected by this increased depreciation would be $1,400 for a taxpayer in the 70 per cent bracket. The present value at 6 per cent interest of all twenty of these annual reductions is approximately $16,000. Since the present value of the annual tax reductions is much greater than the $10,000 tax which must be paid to realize the reductions, the taxpayer should elect to report the gain.

These computations should also be followed by a corporate taxpayer. Assuming the same facts as in the above example and a tax rate of 48 per cent, the annual tax reduction from the increased depreciation is $960 (48 per cent times $2,000). The present value of twenty annual tax reductions of $960 is approximately $11,000, still greater than the $10,000 tax payable on the gain.

Severance Damages

Frequently, a condemning authority will require only a portion of a total parcel of land. Such a situation might arise as a result of a street widening project or the construction of a new highway through a farm. Only that portion of the property required for the project will be condemned, and the award for the condemned portion is treated under the rules set forth above. Many times, however, the loss of only a portion of the land parcel impairs the usefulness of the portion not condemned. For example, a widened street could eliminate a factory's shipping and receiving area, thereby necessitating rearrangement of factory operations and construction of a new shipping and receiving area. The property owner is compensated for this impairment of usefulness just as he is compensated for the portion of property condemned. The compensation for the impairment of usefulness is known as severence damages. The award for severance damages is frequently offset in part by a special assessment against the retained portion of the property. Assessments are levied on the ground that the retained property has been benefitted by the improvement for which the condemned property was used, as in street widening projects.

The tax treatment of severance damages varies slightly from that for the award for the property condemned. Severance damages are treated as compensation in the following order for (1) legal and other expenses incident to the condemnation, (2) special assessments, if any, (3) expenses necessary to restore the usability of the retained property, and (4) the retained property itself. Any portion of the severance damages remaining after the basis of the retained property has been reduced to zero is capital gain.

Condemnation awards do not always stipulate the portion which is severance damages even though severance damages were considered in determining the amount of the total award. However, it is generally to the taxpayer's advantage for a portion of the award to be treated as severance damages, since the award for severance damages is not taxable unless it exceeds all of the items listed in the preceding paragraph. The Internal Revenue Service has taken the position that the total condemnation award is for the condemned property alone unless the condemning authority and the property owner clearly stipulate that an ascertainable portion of the award is severance damages to the retained property. Where severance damages are considered in reaching a settlement with a condemning authority, the taxpayer should insist that the agreement for sale state clearly the respective dollar amounts which are for the land taken and for severance damages to the retained land.